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Dividends from Wasting Assets Corporations

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DIVIDENDS FROM WASTING ASSETS CORPORATIONS

"Logic supplies a probability, but it is not remorseless."[1] In no field of the law is the statement more true than in corporation finance. Particularly as to corporate dividends, business practice and accounting methods frequently displace logical deductions from statutory language. Few topics are so commonly a matter between directors and their counsel as the legality of a suggested dividend; yet rarely is the profession able to furnish a definite opinion.[2] The problem becomes even more complicated when the charter provides for participating preferred stock or non-cumulative preferred, for income bonds or hybrid securities of a similar sort.[3] Indeed, the

[1] WILLISTON, SOME MODERN TENDENCIES IN THE LAW (1929) 157.

[2] Weiner and Bonbright, *Anglo-American Dividend Law: Surplus and Profit* (1930) 30 COL. L. REV. 954, 984.

[3] Note (1936) 45 YALE L. J. 907.

articles of the present-day corporation are as wearisome in their puzzling stock classifications, embracing manifold dividend preferences along with limited voting rights, as an Austinian treatise on jurisprudence.[4] Recent enactment by the West Virginia legislature of an amendment authorizing dividends from wasting assets corporations has now in part at least clarified the legal situation as to local corporations.[5]

Historically, the commercial theory of dividends is of relatively recent growth. The seventeenth-century trading corporations contemplated merely a temporary investment of capital, — not a permanent one. Issues of stock were floated so that a specific enterprise might be carried through; thereafter, within a very few years, the bulk of the stock was always retired and the shareholders paid off. Only gradually did the notion develop that a capital contribution need not be repaid to the business associate, but might remain as a permanent fixed investment.[6] When, upon reorganization of the East India Company in 1702, the new concern issued shares representing a permanent issue of stock with definite par value, the concept of fixed capital became established in early corporate practice. During the eighteenth century, with the institution of stock certificates, investors soon came to think in terms of dividends instead of considering as of primary importance the early repayment of sums advanced. Nevertheless, despite this modern thought of the contributor as having a stake in the business unit, a distinction between fixed capital and floating capital has persisted in English "dividends law" down to the present, simply as an historical survival from the time of the trading companies.[7]

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[4] GRAY, NATURE AND SOURCES OF THE LAW (1909) § 14: "This is the great merit of Austin. His style is inexpressibly wearisome. He himself once expressed a doubt whether his love-letters were not written in the fashion of an equity draughtsman; and certainly his treatise resembles in manner more the charging part of an old bill in equity than any other kind of human composition."

[5] W. Va. Acts 1935, c. 24, passed March 9, 1935, in effect ninety days from passage; the amendment has now become W. VA. REV. CODE (1931) c. 31, art. 1, § 70, second paragraph. The text is as follows: "Subject to any restrictions in its charter, the directors of any corporation engaged in the exploitation of wasting assets may determine the net profits derived from the exploitation of such wasting assets without taking into consideration the depletion of such assets resulting from lapse of time or from necessary consumption of such assets incidental to their exploitation."

[6] Berle, *Origin of American Corporation Law* 71, 81, REPORT OF COMMITTEE ON OHIO CORPORATION LAW OF OHIO STATE BAR ASSOCIATION (January 16, 1928).

[7] PALMER, COMPANY LAW (13th ed. 1929) 226; *cf.* Dovey v. Cory, 1901 A. C. 477, 487, *per* Halsbury, L. C.: "I desire, as I have said, not to express any

Fortunately, such an artificial differentiation of capital assets has never been received over into American jurisdictions:[8] if the vexatious issue of capital replacement serves to confuse American courts, no assistance can be had from English case-law on the point. English and American theories of corporation law thus sharply diverge on the relation of capital to dividends.

In America, the declaration of dividends is almost always a matter of statutory permission: the lawyer must look to the precise language of the local code, in order to ascertain the legal wisdom of the proposed distribution. More often than not, decisions from other states are of little help, where these are based on wholly different enactments.[9] Again, the particular provision of the act may ambiguously use the terms *capital* and *capital stock* interchangeably,[10] thus rendering extremely important the existence of capital losses through depreciation[11] or depletion.[12] Usually one finds that various statutory tests have been promulgated, such as those forbidding dividends promoting insolvency, or dividends diminishing the amount of capital, and requiring dividends to be declared only from net profits. In some states, perhaps only one of such limitations may be found; in others, these may all co-exist and sometimes conflict, along with additional safeguards skillfully or unskillfully devised by the legislature.[13] It is not unwise to generalize that no aspect of American corporation law is more unsatisfactory than the dividends sections of the codes.[14]

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opinion, but as an illustration of what difficulties may arise the example given by the learned counsel of one ship being lost out of a considerable number, and the question whether all dividends must be stopped until the value of that lost ship is made good out of the further earnings of the company or partnership, is one which one would have to deal with."

8 Wittenberg v. Federal Mining & Smelting Co., 15 Del. Ch. 147, 156, 133 Atl. 48, 52 (1926).

9 Weiner, *Theory of Anglo-American Dividend Law: American Statutes and Cases* (1929) 29 COL. L. REV. 461, 462.

10 Weiner, *op. cit. supra* n. 9, at 467; see Note (1927) 75 U. OF PA. L. REV. 350, 356: ". . . the inference is justifiable that the safeguard afforded the stockholder, preferred as to capital, extends to the actual capital of the company, whatever the court decides that capital to be, whether it is merely the actual invested capital originally paid in for shares as capital, or is the par value of all outstanding shares."

11 Vogtman v. Merchants' Mortgage & Credit Co., 178 Atl. 99 (Del. Ch. 1935).

12 Under the income tax provision of the federal revenue acts, an amount may be deducted from operating income for depletion.

13 Weiner, *op. cit. supra* n. 9.

14 For example, in the REPORT OF COMMITTEE ON OHIO CORPORATION LAW OF OHIO STATE BAR ASSOCIATION (September 18, 1928), it is stated that the

Until a decade ago, the question of dividends from wasting assets corporations had scarcely received legislative consideration.[15] The issue was thus a matter simply of statutory interpretation. Two possible courses were available to the courts. On the one hand, the statutory prohibition against dividends out of capital might be construed to mean exactly what the language said, — namely, no dividends out of capital. In other words, employing the test of the "single plain meaning",[16] declarations of such dividends would in most instances be illegal. On the other hand, it might be decided that there was a well-recognized exception "established by the common law[17] and engrafted upon the pertinent statutory law"[18] sanctioning these dividends, even though the capital of the wasting assets corporation might thereby be impaired. Employing this approach, the court could hold the common-law exception supplemented and even superseded the legislative prohibition, so that in the instance of wasting assets the statute did not mean what it said.[19] Thus, the investor might obtain a return of his capital at once, without waiting for dissolution or going through the complicated process of statutory reduction of capitalization.[20] The only difficulty with this second line of reasoning was that it pre-supposed a common law of dividends: in the United States, the contrary has generally been assumed. In short, such a common-law exception to a clear statutory rule might almost seem to be a square peg in a round hole. Logically, the doctrine would thus be an indefensible one.

Curiously enough, the theory of the legality of dividends from wasting assets corporations is barely a half century old, with decisions from only a few scattered jurisdictions. In 1886, Victor Morawetz discussed the problem for the first time, in his treatise on Private Corporations.[21] After stating that the whole capital

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dividends section is the most widely criticized provision of the new Ohio Corporation Code.

15 The first such act was the Delaware law of 1927. By the term wasting assets is meant not only that class of properties which may be consumed, such as timber reserves, mines and oil wells, but also the type which expires by lapse of time, such as leaseholds and patents.

16 See Hardman, *A Problem in Interpretation* (1936) 42 W. VA. L. Q. 110.

17 STEVENS, CORPORATIONS (1936) 396; Federal Mining & Smelting Co. v. Wittenberg, 15 Del. Ch. 409, 417, 138 Atl. 347, 351 (1927).

18 Federal Mining & Smelting Co. v. Wittenberg, *supra* n. 17.

19 *Cf.* Bee v. Huntington, 114 W. Va. 40, 46, 171 S. E. 539, 542 (1933).

20 W. VA. REV. CODE (1931) c. 31, art. 1, § 13(a).

21 MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS (2d ed. 1886) § 442.

originally contributed by the shareholders should be put into the business and kept there, — and that no part of it should be taken out again, directly or indirectly, and given back to the shareholders, — the author then laid down a different rule applicable to mining companies. When dealing with a corporation whose sole purpose was to invest its capital in a specific piece of property like a mine, in order to consume the property or extract its value at a profit, Mr. Morawetz said that its dividends were both legal and within the contemplation of the corporate charter. It was to be implied from the character of the speculation of a mining company that the income derived from working the mine should be distributed among the shareholders as dividends, after deducting the expenses and making reasonable provision for contingencies. No authorities, however, were cited for such a novel proposition.

Almost contemporaneously, the leading case of *Lee v. Neuchatel Asphalte Company*[22] was decided by the Court of Appeal in England. In that litigation, a minority shareholder sought to enjoin the distribution of a dividend by an asphalt company, on the ground that the concession held by the company was a wasting asset, which had during the years become depreciated both by lapse of time and by exhaustion of the subject-matter. Since no sinking fund had been set apart to meet such depreciation in the value of this wasting property, the plaintiff claimed the dividend was being paid out of capital. At the trial, the proof showed that the company's existing concession was for a longer period, extended over a wider area, and was held on more favorable terms than the original grant to the company upon its organization. Moreover, there was no probability that the entire amount of asphalt available for extraction could possibly be gotten out, even during the life of the later concession. In these circumstances, it was impossible for the plaintiff to establish that there had in fact been capital loss, nor that there would be actually a diminishing of capital through the distribution of dividends: hence, the court refused relief. The *Neuchatel Asphalte* case has been widely cited. on both sides of the Atlantic, as establishing the common-law principle favoring dividends from wasting assets corporations. Yet it is pertinent to note that no statute was involved; moreover, the old distinction between fixed capital and floating capital was once more before an English court. The decision can hardly be con-

[22] Lee v. Neuchatel Asphalte Co., 41 Ch. D. 1 (1889).

sidered as being applicable in this country, or even as having persuasive weight except on its precise facts, — namely, where a wasting assets corporation, whose properties have increased in value, distributes its income as dividends, in the absence of a statute forbidding dividends from capital. In any event, later English judicial utterances[23] have severely limited the scope of the *Neuchatel* doctrine. Its present legal significance has been summarized by Farwell, L.J.:[24]

> "In my opinion that is not the true result of the decision; the company's assets were larger than at its formation, and the Court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund. For instance, I cannot think that it would be right for the defendant company to purchase out of capital the last two or three years of a valuable patent and distribute the whole of the receipts in respect thereof as profits without replacing capital expended in the purchase."

While presumably the issue has constantly been before corporate managers in this country, the case-law on the point is amazingly scarce. Furthermore, most of the cases cited in support of the wasting asset doctrine are either mere *dicta,* or else are not concerned with the problem of dividends. In *Excelsior Mining Company v. Pierce,*[25] the California court held that, after deducting the gross outlay of a mining company from its gross receipts, the balance would be the legitimate subject of a dividend: the statement was pure *dictum,* wholly unnecessary to the decision. *People v. Roberts*[26] involved the meaning of "capital stock employed in the state", as used in the New York Franchise Tax law; it was decided that surplus earnings of a mining company were not taxable as "capital", since the directors were not required to establish a depletion reserve. Similarly, *Boothe v. Summit Coal Mining Company*[27] had to do with the word "profits" as used in an agreement to purchase stock: its analogy for dividends purposes seems somewhat far-fetched. Perhaps the strongest single American authority is that of *Mellon v. Mississippi Wire Glass*

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23 PALMER, COMPANY LAW (13th ed. 1929) 227-228.

24 Bond v. Barrow Haematite Co., (1902) 1 Ch. 353, 367-368. The learned judge added: "It is for the Court to determine in each case on evidence whether the particular company ought, or ought not, to have such a fund."

25 90 Cal. 131, 27 Pac. 44 (1891).

26 156 N. Y. 585, 51 N. E. 293 (1898).

27 55 Wash. 167, 104 Pac. 207 (1909).

Company,[28] in which a preferred stockholder sought to compel the maintenance of a sinking fund for the benefit of the preferred stock, prior to the declaration of dividends on the common stock. There was nothing in the corporate articles sanctioning the establishment of such a sinking fund, so that the court was being asked by the complainant to make a new contract between the parties. Under these conditions, the vice-chancellor ruled that there was no power in the court to accord the relief sought. It will be noted, however, that the question presented was the creation of the sinking fund: the theory of the bill was not the enjoining of the dividends as disbursements of capital. More important, it did not appear that there was any deficit in capital assets even after making a reasonable allowance for depletion. Other decisions such as *Van Vleet v. Evangeline Oil Company*,[29] — involving a stockholder's petition for the appointment of a receiver on the ground of mismanagement, — and *Stratton's Independence, Ltd. v. Howbert*,[30] having to do with the deduction of depletion in income tax returns, — are all distinguishable. *Per contra*, it has been held that a coal mining company may establish a sinking fund for eventual redemption of its stock, despite objection from its minority stockholders.[31] Moreover, when dividends are actually paid by a wasting assets corporation, the life tenant under a trust will be allowed only a fair rate of interest.[32] Thus, by and large, American case-law has scarcely been convincing as to the legality of such dividends. No doubt courts were reluctant to sanction the establishment of such a doctrine, thought by many to be economically unsound[33] and opposed both to the spirit and letter of dividends statutes.

A few years back, *Wittenberg v. Federal Mining and Smelting Company*[34] summed up the common-law position in this country. A preferred shareholder sued to enjoin the payment of a de-

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28 77 N. J. Eq. 498, 78 Atl. 710 (1910).

29 129 La. 406, 56 So. 343 (1911).

30 207 Fed. 419. (1912); *aff'd* on other grounds, 231 U. S. 399, 34 St. Ct. 136 (1913).

31 Ford v. Locust Mountain Coal & I. Co., (1868) 25 Phila. Leg. Int. (Pa.) 268.

32 *In re* Wells, 156 Wis. 294, 144 N. W. 174 (1913).

33 Comment (1926) 40 HARV. L. REV. 318. Obviously, however, whether the doctrine is or is not economically unsound will depend upon the mineral wealth of the jurisdiction in which it is applied.

34 Wittenberg v. Federal Mining & Smelting Co., 15 Del. Ch. 147, 156, 133 Atl. 48, 52 (1926); Federal Mining & Smelting Co. v. Wittenberg, 15 Del. Ch. 409, 417, 138 Atl. 347, 351 (1927).

clared dividend which, it was alleged, would reduce the assets of the corporation below the amount necessary to pay off the preferred stock on a distribution. The dividend was to be distributed from profits for one particular year, without deduction for depletion of assets. Both the chancellor and the Supreme Court of Delaware refused to admit the validity of the wasting assets doctrine, at least in such a case as was there presented.[35] It may fairly be said that the purport of the *Wittenberg* decisions was definitely opposed to the statements of American text-writers and the *dicta* in American cases approving such dividends.

Following the *Wittenberg* decision, corporate counsel realized as never before the necessity for specific statutory authorization of wasting assets dividends. Accordingly, a carefully drawn act was adopted by the legislature of Delaware,[36] enabling the Chancellor to refuse relief in his final disposition of the Wittenberg litigation. Shortly thereafter, Ohio adopted a somewhat similar statute,[37] the language of which was carried over by the drafters into the Uniform Business Corporation Act.[38] The recent West Virginia statute follows the Delaware phraseology, but unfortunately omits the very salutary provision for establishment of a reserve fund for depletion purposes.

What then is the situation in West Virginia to-day as to dividends from wasting assets corporations? Presumably, in the absence of the 1935 statute, such a dividend would have been improper, both from the angle of sound accounting practice and in the light of the West Virginia statutes involved. In this connection, the best accounting authority has taken the position that such dividends are to be regarded as a payment in part out of profits and in part out of capital.[39] American courts confronted with the problem have hardly dared to be so frank, when dealing with statutes expressly forbidding distributions out of capital: otherwise, violations of the law would thus have been sanctioned. It is not unreasonable, therefore, to view the new West Virginia act as one enacted in derogation of the common law. Yet the change has unquestionably been a desirable one, having regard

[35] In this litigation, there were two classes of stock. The preferred stock was entitled to preference in the distribution of capital, upon dissolution of the corporation.

[36] Del. Laws 1927, c. 85, § 34.

[37] OHIO GEN. CODE (Page, 1926) §§ 8623-38. The section was amended slightly in 1929.

[38] UNIFORM BUSINESS CORPORATION ACT (1928) § 24, VII.

[39] HATFIELD, ACCOUNTING (1928) 279.

especially to the coal industry and to the extensive oil and gas fields in this state. Mining companies here more commonly have but one class of stock, so that any question of preference in capital distribution becomes largely academic. The new law then merely approves a course of corporate conduct which has probably existed locally for years, even despite express code provisions.[40]

Viewed in this background of common law and local economic conditions, the specific provisions of the 1935 amendment deserve careful consideration. To begin with, the wasting assets doctrine is enacted in explicit language, but *subject to any restrictions that may be contained in a corporate charter.* In other words, by erecting a corporate structure with two or more classes of stock, with provisos for preference in distribution of capital upon dissolution, the shareholders may expressly or impliedly contract out of the benefits of the new section. It is next important to note that the decision as to the declaration of dividends in the ordinary wasting assets corporation is left to the discretion of the directors. Thus, their conduct continues to lie within the field of non-reviewable directorate action, so long as the directors decide prudently and in good faith to permit or to withhold a distribution of profits. Obviously, this salutary practice of confiding the decision to the directors, as in the instance of an ordinary business unit, makes for efficient corporate management. Furthermore, the newly-added section wisely fails to limit by specific language the type of corporation within its purview. It has been left to West Virginia courts to determine whether or not a particular corporation is "engaged in the exploitation of wasting assets": thus, by sound process of trial and error, judicial experience may extend or restrict the application of the statute. Finally, only net profits derived from the exploitation of wasting assets fall within the rule. Hence, if a mining company or an oil or gas enterprise derive revenues from corporate activities other than simply the extraction of minerals, the usual provisions against dividends out of capital will apply as to those specific activities.

It must not be concluded from the foregoing discussion that the wasting assets doctrine has now no other limitations in West Virginia. On the contrary, the directors are still forbidden to declare and pay a dividend when the corporation is insolvent, — or

[40] Most small mining corporations in West Virginia have in the past distributed profits, without regard to considerations of the wasting assets doctrine.

any dividend the payment of which would render it insolvent. Similarly, as pointed out above, the discretion of the directors may be at least impliedly restricted by the detailed classification of stocks involved in the corporate structure. Moreover, the wasting assets doctrine has until now been confined to mines and timber reserves in their natural state, prior to their exploitation.[41] If the timber or the product of the mine is reduced to possession and put into storage, some courts haye treated the product as a current asset, the depletion of which must be made good before computing distributable profits.[42] The distinction in this regard has arisen from the classification of corporate properties into fixed and current assets, — perhaps an unwarranted classification by accountants and courts. Yet, assuming such distinction, coal in a mine might be classed as a current asset, while the mineral in storage might well become a fixed asset, outside of the wasting assets principle.

These and other similar problems remain for West Virginia courts to solve. Meantime, in the application of the wasting assets doctrine, it is important to bear in mind that "the desirability of rules of law obviously depends on how they work." The *caveat* should be that "it is infrequently better to make business custom follow the law than to seek to apply the opposite method."[43]

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[41] Weiner and Bonbright, *Theory of Anglo-American Dividend Law: Surplus and Profits* (1930) 30 COL. L. REV. 330, 339-340.
[42] Van Vleet v. Evangeline Oil Co., 129 La. 406, 56 So. 343 (1911).
[43] WILLISTON, *op. cit. supra* n. 1, 150.